



## **Financial Performance in Nigerian Quoted Companies: The Influence of Political Connection and Governance Mechanisms**

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### **ABSTRACT**

The study examines political connection, governance mechanisms and financial performance relationship, drawing from the agency theory. The study employs a quantitative design, employing cross-sectional data from the annual reports of the sampled companies. The results provide evidence of partial support for the agency theory, as gender was positively related to financial performance, while political connection and Chief Executive Officer incentives were negatively related with performance. The finding of the study should interest organisational stakeholders such as auditors shareholders and managers.

**Keywords:** Accounting, Political Connection, Board, Chief Executive Officer Incentives, Financial Performance, Nigeria

**JEL Classifications:** M, G2

### **1. INTRODUCTION**

An important issue that has been found to highly influential in developing countries is political connection (Poon et al., 2013). Past studies have found political connections explaining the variation in performance (Johnson and Mitton, 2003). Political connections cut across a number of countries, most especially countries that are perceived as highly corrupt and that impose restrictions on foreign investments by their citizens (Faccio, 2006). Also, politically connected firms are widely perceived to entail poor corporate governance practices and are more risky as perceived by stakeholders such as auditors and lenders (Abdul et al., 2009; Bliss and Gul, 2012a; Fraser et al., 2006). In the Nigerian environment, a politically connected firm has been viewed as one where a former board member is currently occupying a political appointment, or one of its top shareholders, is currently occupying a public office (Aburime, 2009; Osamwonyi and Tafamel, 2013).

Also likely to influence financial performance as has been highlighted by a number of studies, is the governance structure

in place (Bhagat and Bolton, 2008; Core et al., 1999). Corporate governance issues have become a worldwide problem, as is evident in the number of corporate governance reports that have been issued in a number of countries (Rossouw, 2005). Despite the day to day activities of the board cannot be easily observed (Adams et al., 2010), they are a key component of the internal corporate governance mechanism of the firm designed to monitor managers (Fama, 1980). The board of directors is particularly important in developing economies, characterized by relatively weak governance mechanisms and institutions such as market for control, financial markets, regulators, monitoring and legal system (Ujunwa et al., 2013). It has been observed that the effectiveness of the board is impaired by information asymmetry which leads to the agency problem between management and shareholders, whereby managers exploit the shareholders (Fama and Jensen, 1983). This has been adjudged to be responsible for several corporate failures in Nigeria, especially as was seen in the banking sector (Oso and Semiu, 2012).

Theoretically, despite a number of studies have investigated the nexus between political connection and financial performance

(Bliss and Gul, 2012b; Chen et al., 2004; Johnson and Mitton, 2003; Osamwonyi and Tafamel, 2013), within the Nigerian context, the literature is still relatively scarce as only one study to the best of our knowledge has investigated the relationship between political connection and firm performance. Further, considering the governance attributes and firm performance relationships, prior studies have found the results to be mixed (Allegrini and Greco, 2013; Oxelheim and Randoy, 2003), hence providing justification for future studies. Also, to the best of our knowledge there are no studies that have investigated the role of Chief Executive Officer (CEO) incentives in influencing the financial performance of firms within the Nigerian context.

Following the issues highlighted, the objective of this study is therefore to examine the relationship between political connection, governance mechanisms and financial performance in Nigerian quoted firms. This study makes several contributions to the body of literature. Firstly, the study examines the relationship between political connection and financial performance in Nigeria. Secondly the paper also adds to the literature on corporate governance, the study investigates, the role of several governance mechanisms for instance, CEO Incentive, and foreign presence on financial performance that have also not been studied previously within the Nigerian environment. Lastly, the study employs a large sample relative to the Nigerian environment, as most of the prior studies were deficient in terms of the sample size.

## 2. LITERATURE REVIEW

### 2.1. Theoretical Framework: Agency Theory

Issues concerning strategic planning and business policies are largely influenced by agency theory (Donaldson and Davis, 1991). The isolation of ownership from control results in the problem of information asymmetry and leads to a conflict of interest between management and shareholders (Fama, 1980; Jensen and Meckling, 1976). Agency theory argues that there is an agency loss which is the shortfall in returns available to residual owners as a result of direct control being in the hands of managers (Jensen and Meckling, 1976). Agency theory therefore proposes a way out to reduce this loss (Eisenhardt, 1989). Corporate governance mechanisms can aid financial performance. For instance, agency theory predicts that better financial performance can be expected from companies whose corporate governance structure is such that there is intensive monitoring in the form of, large board size which plays a crucial role in board effectiveness (Raheja, 2005) and foreign directors in the board, as there is a greater push for performance by foreign owners as a result of geographical separation (Craswell and Taylor, 1992; Schipper, 1982). This intensive monitoring ensures the manager desists from embarking on any form of opportunistic behaviour and as such, the managers cannot withhold information for their benefits. In this study, the critical variables that will be studied include political connection, governance mechanisms and financial performance.

### 2.2. Hypotheses Development

#### 2.2.1. Political connection

In the course of this study, a politically connected company is defined as where there exist in the company, a director who is an existing

or former political appointee of the government, military or ex-military personnel. Prior studies have shown a negative relationship between political connection and firm performance. Johnson and Mitton (2003) found the stock prices of politically connected firms falling lower than non-favored firms during the 1997 Asian financial crisis. They explain this by the fact that the market saw politically connected firms as being inefficient. Similarly, Fan et al. (2007) found the accounting and stock return performance of the firms run by politically connected CEOs poor in relation to their politically unconnected counterparts as such politically connected firms have boards exhibiting low degree of professionalism, as fewer directors have relevant professional backgrounds. Also, (Bliss and Gul, 2012a; Boubakri et al., 2008) find that politically connected firms in Malaysia have a higher likelihood of reporting a loss than non-connected firms. Fulfilling the propositions of prior studies and related theory, the research proposes that:

H<sub>1</sub>: There is a negative relationship between political connection and financial performance.

#### 2.2.2. Board size

Board size has been defined as the total number of directors available for the year, which includes executives and non-executive directors (Wang and Hussainey, 2013). The literature on governance have largely supported the arguments that large boards are more effective than smaller boards (Allegrini and Greco, 2013; Barako et al., 2006; Klein, 2002). This is so for several reasons. For instance, larger boards are less intimidated by the executive directors, as they usually contain a relatively large number of non-executive directors. Also, large boards have a greater chance of containing diversity of expertise which might include environmental sensitive directors. In similar vein, Frias-Aceituno et al. (2013) further affirm that the larger the size of the board, the more the integration of corporate information. In other words, the greater the breadth of knowledge available within the board, the more the number of information documents that can be attended to which in turn addresses the needs of a larger group of stakeholders. Fulfilling the propositions of prior studies the research proposes that:

H<sub>2</sub>: There is a positive relationship between board size and financial performance.

#### 2.2.3. Foreign presence

The issue of board diversity is becoming a trendy issue in corporate governance structures. Carter et al. (2003) argue in support of board diversity that it provides for a more independent board as a director with a different ethnicity or cultural background might probe into issues that will not naturally come from directors with more traditional background. Furthermore, Gulamhussen and Guerreiro (2009) provide strong evidence of a negative relationship between the presence of foreign board members and operating costs consistent with the school of thought that foreign board members bring diversity of knowledge, expertise and objectivity, thereby improving the organizational structure and efficiency. Also, Oxelheim and Randoy (2003) investigating the impact on firm value of a foreign based board found a significantly higher Tobin q for those firms with foreign directors sitting on

their board. Fulfilling the propositions of prior studies the research proposes that:

H<sub>3</sub>: There is a positive relationship between foreign presence and financial performance.

#### 2.2.4. CEO incentives

CEO incentive in the context of this study, relates to ownership of shares by the CEO. It can result in better monitoring of the management as lack of ownership of shares have been attributed to the reason behind executives behaving in an opportunistic way (Zahra et al., 2000). In line with the agency theory, when CEO incentives are high, there is the tendency to act in the interest of shareholders. Westphal (1999) found that CEO incentives led to a higher firm performance. Similarly, Deckop et al. (2006) found that a long term CEO pay focus was positively related to corporate social performance. Fulfilling the propositions of prior studies the research proposes that:

H<sub>4</sub>: There is a positive relationship between CEO incentive and financial performance.

#### 2.2.5. Board gender

The agency theory purports that gender diversity may result in an increased independence of the board as women are more objective in asking questions than men (Carter et al., 2003; Fama and Jensen, 1983). Barako and Brown (2008) find evidence that women are more inclined towards CSR and disclosures. In addition Farrell and Hersch (2005) also add that the positive relationship between female directors on the board and firm value can be explained by female directors having the liberty of choosing to serve on better performing firms as a result of their scarcity.

Fulfilling the propositions of prior studies and precedence of prior literature the research proposes that:

H<sub>5</sub>: There is a positive relationship between board gender and financial performance.

#### 2.2.6. Firm size

Key features of a large firm are its diverse capabilities, the ability to exploit economies of scale and the formalization of procedures (Majumdar, 1997). Barbu et al. (2014) provide evidence showing that large firms are likely to comply more with IFRS than are smaller firms. Further, Awadh and Abdul (2015) found size having a positive relationship on firm performance. Their findings show that large firms have lower cost of information collection, more resources and lower risks in financial markets resulting in better performance. Fulfilling the propositions of prior studies and precedence of prior literature the research proposes that:

H<sub>5</sub>: There is a positive relationship between firm size and financial performance.

## 3. METHODOLOGY

### 3.1. Sample Selection and Data Collection

The sample comprised all firms in the main stream of the Nigerian stock exchange market as at 2013. From this sample, companies

with unavailable data as at the time of collecting data for this study are removed to arrive at a final sample of 119 companies, which is deemed appropriate based on the scientific guideline for determination of sample size as developed by (Krejcie and Morgan, 1970). The sample comprised financial and non-financial companies as both groups are expected to be profitable. The annual reports are used in the collection of data for this study, due to its degree of reliability and widespread acceptability by organizational stakeholders (Deegan and Rankin, 1997; Haniffa and Cooke, 2005).

### 3.2. Measurement of Variables

The measurements of the variables are shown in Table 1.

### 3.3. Model Specification

In order to test the above hypotheses, the model specification is structured based on ordinary least square regression analysis. It is illustrated below:

$$\text{PROF} = \beta_0 + \beta_1 \text{PCON} + \beta_2 \text{BSIZE} + \beta_3 \text{FOREPR} + \beta_4 \text{CINCENT} + \beta_5 \text{BGEND} + \beta_5 \text{FSIZE} + \epsilon_t$$

Where, PROF=Profitability; PCON= Political connection; BSIZE=Board size; FOREPR=Foreign presence; CINCENT=CEO incentives; BGEND=Board gender; FSIZE=Size of the firm.

## 4. RESULTS AND DISCUSSIONS

### 4.1. Descriptive Analysis

In Table 2, the description of the variables used in the study are presented. The variables comprise the dependent variable which is profitability, the hypotheses variables, which include political connection, board size, foreign presence, CEO incentives and board gender. Lastly the control variable which is firm size. It can be observed from the results that the minimum return on equity (ROE) which is used as a proxy for profitability is -0.94, while the maximum is 2.29 and the average is 0.14. This reveals that while most of the firms are profitable, some firms also made losses during the period. Amongst the sampled firms, on the average, about 54% of the firms appeared to be politically connected. Furthermore, on the average, the number of directors on the board of firms quoted in the Nigerian stock exchange market as at 2013 is about 9 directors. On the average about 17% of these directors are foreigners, while 11% are females. The average ratio of CEO shares to the total number of shares is 0.05, and the average log of total assets which is used as a proxy for size of the firm is 16.50.

### 4.2. Correlation Analysis

In the course of the analysis, the presence of multicollinearity in the regression model is examined through the correlation coefficients. Table 3 presents the correlation results for all variables. The result shows a weak positive relationship between PROF and all variables. This suggests that the variables are not measuring the same thing and there is absence of multicollinearity in the model. The result of the variance inflation factor further confirms the results as it gives a value of all variables is run as it gives a value of 1.35.

**Table 1: Constructs of the variables**

Explanatory variables	Measurement	Sources
Financial performance (profitability [PROF])	Profit after tax/total equity	(Che-Ahmad and Osazuwa, 2015b)
Political connection (PCON)	Dummy variable 1 if political connection exists and 0 otherwise	(Johnson and Mitton, 2003)
Board size (BSIZE)	The total number of directors available on the board each accounting year	(Abidin et al., 2009; Akhtaruddin et al., 2009)
Foreign Presence (FOREPR)	The percentage of directors that are foreigners to total directors	(Gulamhussen and Guerreiro, 2009; Liang et al., 2013)
CEO Incentives (CINCENT)	Number of shares owned by CEO divided by the total number of shares	(Westphal, 1999)
Board gender (BGEND)	Proportion of female directors to total directors on the board	(Liao et al., 2014)
Firm Size (FSIZE)	natural log of total assets	(Che-Ahmad et al., 2003; Wan Hussin et al., 2005)

**Table 2: Descriptive statistics for disclosing and non-disclosing firms (n=119)**

Variable	Min	Max	Mean±Standard deviation
PROF	-0.94	2.29	0.14±0.30
PCON	0	1	0.54±0.50
BSIZE	5.00	17.00	9.06±2.53
FOREPR	0.00	0.75	0.17±0.21
CINCENT	0.00	0.64	0.05±0.12
BGEND	0.00	0.44	0.11±0.11
FSIZE	11.37	21.78	16.50±2.03

PROF: Profitability, PCON: Political connection, BSIZE: Board size, FOREPR: Foreign presence, CINCENT: CEO incentives, BGEND: Board gender, FSIZE: Size of the firm, CEO: Chief Executive Officer

### 4.3. Multiple Regression Analysis

Reporting the results of the ordinary least square regression requires that certain diagnostic tests have to be conducted to ensure that the results reported can be relied upon (Gujarati, 2003). It is important to check that there is absence of multicollinearity and there is no problem of heteroskedasticity. The results of the Breuch Pagan test for heteroskedasticity, with a p-value of 0.00, shows that the model is heteroskedastic. This is then corrected for using the robust regression analysis (Hoechle, 2007). Table 4 presents the results of the ordinary least square regression with profitability as the dependent variable. There is an obvious improvement in the significance of the variables when the robust regression is run.

Hypotheses 1-6 predicts that a positive association exists between political connections, board characteristics (board size, foreign presence, CEO incentives, and board gender), firm size and profitability of the sampled firms. The result of the robust regression shows a significant negative relationship for political connection ( $\beta = -0.08$ ,  $P < 0.10$ ) and CEO incentives ( $\beta = -0.38$ ,  $P < 0.05$ ), while a positive relationship was found for board gender on the relationship with profitability of the sampled firms. The results for board size, foreign presence and firm size were not significant. Hence only Hypotheses 5 is supported.

## 5. DISCUSSION OF FINDINGS

The objective of the study was to examine the relationship between political connection, board characteristics and financial performance in Nigerian firms. The results show partial support

for the agency theory that explains the role of governance mechanisms in resolving the agency problem. The positive relationship between board gender and the financial performance is in tandem with studies by Carter et al. (2003) that considered the nexus between board diversity and firm value. They purport that greater diversity will lead to more independence and subsequent better performance. The result also agreed with (Campbell and Mínguez-Vera, 2007) that found gender positively related to firm value. The negative result reported between political connection and financial performance is in line with the study of (Tu et al., 2013) that investigated how privatized firms were acquired by politically connected persons and how the firms behaved after their acquisition.

The study showed that such firms received preferential treatment and faced post privatization tunneling, which lead to dwindling performance after privatization. Similarly as is the case with (Linck et al., 2008), the negative relationship between CEO incentives and financial performance could be interpreted to mean that the CEO with increased shares, can threaten and dilute the effect of the board of directors (Boyd, 1994; Dalton and Kesner, 1987). As such they could influence the appointment of outside directors and make the board a rubber stamp.

## 6. CONCLUSIONS AND RECOMMENDATIONS

The study examined the relationship between political connection and governance mechanisms on financial performance in Nigeria. The main findings show board gender to have a positive relationship with financial performance, while negative associations were found for the relationships between political connections, CEO incentives on the firm's financial performance. In drawing conclusions based on the findings of this study, it should be noted that the data used is cross-sectional. Future studies may consider extending the time frame. In addition, the study defined financial performance based on the ROE measure of profitability. Future studies might consider other measures of financial performance such as Tobin q, return on assets, earnings per share etc.

The findings of this study should interest organizational stakeholders. Particularly, the negative association of political

**Table 3: Correlation matrix**

Variables	PROF	PCON	BSIZE	FOREPR	CINCENT	BGEND	FSIZE
PROF	1.00						
PCON	-0.13	1.00					
BSIZE	-0.01	0.27***	1.00				
FOREPR	0.03	-0.04	0.02	1.00			
CINCENT	-0.15	-0.04	-0.21**	-0.15	1.00		
BGEND	0.09	0.08	0.13	-0.26***	-0.10	1.00	
FSIZE	-0.03	0.24***	0.65***	0.11	-0.25***	0.19**	1.00

Correlation is significant at \*\*P<0.05, \*\*\*P<0.01 (two-tailed). Variable definition: PROF: Profitability, PCON: Political connection, BSIZE: Board size, FOREPR: Foreign presence, CINCENT: CEO incentives, BGEND: Board gender, FSIZE: Size of the firm, CEO: Chief Executive Officer

**Table 4: Regression analysis**

Variables	Dependent variable: Profitability (ROE)				
	OLS regression			Robust regression	
	Predicted sign	coefficient value	t-stat	coefficient value	t-stat
PCON	+	-0.08	-1.39*	-0.08	-1.47*
BSIZE	+	0.01	0.25	0.01	0.19
FOREPR	+	0.06	0.43	0.06	0.65
CINCENT	+	-0.38	-1.53*	-0.38	-1.86**
BGEND	+	0.31	1.15	0.31	1.39*
FSIZE	+	-0.01	-0.67	-0.01	-0.38
	R <sup>2</sup> =0.05, F-statistic=1.05 P=0.40			R <sup>2</sup> =0.05, F-statistic=2.16 P=0.05	

\*P<0.10, \*\*P<0.05 (one-tailed). OLS: Ordinary least squares, ROE: Return on equity

connection with financial performance has implication for auditors, shareholders and management. The study recommends that external auditors be made to pay particular attention to politically connected firms as political connections have tendencies to weaken the governance structure within the firms. Also, the study highlights the need for policy makers to harmonize and develop corporate governance standards and practices that takes into consideration the specific needs of the African continent. Furthermore, the study recommends more females to be considered into directorship positions, since they play a significant role in shaping the transparency of the board for better performance. Lastly, the study has implication for research as there is a dearth of studies from the Nigerian market, considering the different regulatory structure that separates it from other developing and developed economies.

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